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INFORMAL FINANCE IN LOW INCOME COUNTRIES: A SEMINAR REPORT

by

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Abstract

Paper provides a digest of the material covered in a Seminar on Informal Finance in Development held in Washington, D.C. in October 1989. This includes a summary of the major new findings about the informal finance reported in the Seminar, a suggested agenda for new research on this topic, and a list of policy suggestions raised in the meetings.

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BACKGROUND

Since World War II governments in low income countries, assisted by external donor and nongovernmental agencies, have promoted thousands of credit programs for poor people. These programs make up the bulk of poverty alleviation efforts in many countries. While a few of these endeavors have evolved into sustainable and efficient operations, many more of them were transitory and provided financial services to only a relatively small number of poor people. Most of these projects have been marked by low loan recovery rates, high transaction costs for both lenders and borrowers, insolvent lending institutions, corruption, loans going to individuals who were not poor, and dependence on external funding.[1] Since the early 1970s many of the reasons for the problems in these credit programs have been understood and they were aired extensively in the "Colloquium on Rural Finance in Low Income Countries" held in Washington D.C., September, 1981.[2]

In reaction to the disappointing results from traditional credit programs for the poor, the Agency for International Development (AID) issued a policy paper on financial sector development in 1988 that outlined new guidelines for preparing finance projects more in tune with the recommendations made in the 1981 Colloquium.[3] While some

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[1]The first general recognition of these problems surfaced the in "Spring Review of Small Farmer Credit Programs" carried out by E. B. Rice for the Agency for International Development in 1972-73. For more details on this Review see Gordon Donald, Credit for Small Farmers in Developing Countries, Boulder, Colorado: Westview Press, 1976, and the twenty volumes of papers and studies prepared for the Review.

[2]The Colloquium was sponsored by the Ohio State University, The Agency for International Development, and the World Bank. A summary of the main points made in the Colloquium can be found in Dale W Adams and others, Undermining Rural Development With Cheap Credit, Boulder, Colorado: Westview Press, 1984.

[3]Agency for International Development, Bureau for Program and Policy Coordination, "A.I.D. Policy Paper: Financial Markets Development," Agency for International Development, Washington D. C., 1988. Four main elements were included in the recommended guidelines: placing more emphasis on the vitality of the financial system itself, setting interest rates that accurately reflect market conditions, more emphasis on deposit mobilization, and placing more attention on reducing transaction costs in financial

headway has been made by AID and other donor agencies in encouraging policy changes that facilitate successful finance projects, the progress to date in providing sustainable, formal finance for the poor--both loan and deposit services--has been modest. It is becoming increasingly apparent that, even when conducive policies are in place, it is still arduous and costly to provide formal financial services to many of the poor, especially individuals living in rural areas.

If attention is limited to the difficulties of providing formal financial services to the poor, it is easy to conclude that poverty and sustainable financial services are incompatible. This conclusion has led many policy makers to anticipate and tolerate meager performance from credit programs for poor people. The picture is less bleak if the focus of attention is expanded to include informal financial activities.[4] Recent research is showing that poor people extensively use informal finance and that these arrangements are often sustained over long periods of time.[5]

It is puzzling why informal finance flourishes in the shadows of floundering formal financial systems. A rural bank in the Philippines, for example, may hold a portfolio made up largely of overdue loans, while a merchant in the same village recovers virtually all of the loans she makes. The Agricultural Bank in Bolivia may attract few deposits while many of its own employees are depositing relatively large amounts of funds in informal savings groups. Also, commercial banks in India may find it impossible to provide small loans to poor individuals wishing to buy old vehicles, while informal finance companies conduct a thriving business lending to these clients (Nayar). Similarly, itinerant merchants in Indonesia may make a living selling items door-to-door in rural areas on credit and then collecting payments daily, while formal banks cannot afford to provide these services, even if loans are much larger and borrowers trudge to banks or cooperatives to effect all transactions.

THE SEMINAR

Trying to explain why informal finance succeeds with the poor, while formal finance often fails, was the focus of a seminar on informal finance in low income countries held in Rosslyn, Virginia on October 18-20, 1989. It was sponsored by The Ohio State University, the Bureaus for Science & Technology and Africa of the Agency

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markets.

[4]Informal finance is defined as those loan and deposit activities that are unregulated by a central monetary authority.

[5]For further details on these studies see: Agricultural Finance Program, "Annotated Bibliography on Agricultural Credit and Rural Savings: XIII (A Special Issue on Informal Finance)." Department of Agricultural Economics and Rural Sociology, The Ohio State University, Columbus, Ohio, October, 1989.

for International Development, and the Economic Development Institute and the Agricultural Policies Division of the World Bank. Approximately 150 people attended the seminar and most of them were employees of development agencies, researchers, or students studying development. A total of 36 presentation were made including 24 papers, 10 paper discussants, two discussions of past and future research on informal finance, and a panel discussion on the significance of informal finance for donor agencies (See Appendix A for more details on the Seminar Program).

The seminar had four objectives: First, to bring together a representative group of individuals doing research on informal finance around the world and to allow them to report on their findings. Second, to develop an informal network of individuals who are interested in doing further research in this area. Third, to solicit suggestions from donor employees on the types of research that ought to be done on this topic. And fourth, to design a revised research agenda that might provide information useful in designing finance programs for poor people in low income countries.

MAJOR SEMINAR CONCLUSIONS

Challenged Traditional Stereotypes

Much of the traditional thinking about informal finance emphasizes negative aspects: usury, monopoly profits, labor bonding through lending, and loan defaults leading to collateral seizure by lenders. Most of this thinking has been stereotypical and concentrated on the supposedly evil moneylender who takes advantage of poor people. It has also been commonly thought that informal finance should be eliminated--at least tightly controlled--and that overall formal financial development would cause these activities to wither away.

Traditional thinking about informal finance was challenged by presentations in the seminar. Participants reported finding a kaleidoscope of heterogeneous informal financial arrangements in their research, only a small portion of which was done by full-time professional money lenders. Likewise, there was almost no verbal flogging of informal lenders in the Seminar. Most of the discussion concentrated on the positive aspects of informal finance, how it contributes to the well being of the poor, how it supports development, and useful lessons that can be learned from it. While informal sources provide most of the financial services for poor people--particularly for women--several Seminar participants pointed out that many relatively large firms and well-off people also regularly use informal finance. In some cases, relatively poor individuals or firms may be providing loans to individuals or firms that are relatively well off. Virtually anyone can be an informal lender or borrower.

Several presentations in the Seminar (Onchan, Sanderatne) showed that the relative importance of informal loans has declined the past several decades, but went on to stress that this is largely due to rapid growth in formal lending. It was suggested that informal finance normally expands in absolute terms with the growth of formal finance and the economy in general, and that informal sources usually continue to provide most financial services to the poor, regardless of growth in formal finance. Several participants also reported on cases where recent retractions in formal financial markets resulted in an increase in the relative importance of informal finance (Lamberte, Sanderatne, Schrieder and Cuevas). The absolute expansion in these activities was partly explained by the rapid growth in the informal sector in many countries (de Soto) and partly by the advantages it has in providing certain services (Bouman and Bastiaanssen).

Importance of Informal Savings

Most of the traditional discussions of informal finance stress only debts or loans. Because it is often assumed poor people cannot or will not save and that most of them have a "credit need" that translates into a social entitlement, there is relatively little discussion of informal deposits. The difficulties of collecting information about confidential saving behavior reinforces this assumption and influences the terminology used to describe activities in informal finance: e.g., `informal credit markets,' `rotating credit associations,' and `credit groups.'

In contrast, extensive discussion in the Seminar reported on sizeable deposit and savings activities taking place in informal financial markets. Many of the participants were optimistic about the willingness and ability of even poor people to save in low income countries. A number of participants also argued that savings-deposits were an important element in development of sustainable financial intermediation. In a fundamental sense, large amounts of informal loans are the mirror image of part of the informal savings that emerge in financial form. Someone postpones consumption--saves--in order to accumulate every unit of money lent in informal markets.

A number of the papers presented in the Seminar focused on various aspects of informal savings and deposits (Chimedza, DeLancey, Fernando, Graham, Izumida, Schrieder and Cuevas, Shipton, and Von Pischke) These presentations showed that large amounts of deposits are mobilized through various forms of informal groups, and that savings are a major motivation for people to participate in groups. In some cases the volume of informal financial savings flowing through informal markets may be as large or larger than the volume of deposits in banks (Cameroon). The large volume of voluntary savings moving through informal markets also suggests that formal financial markets often fail to offer attractive deposit services, especially to poor people. The widespread use of moneyguards as a place to deposit interest-free funds is a vivid indication of this failure (Graham, Shipton).

The gender issue is particularly important in informal savings. Many of the individuals who are involved in informal savings activities are women (Chimedza, DeLancey, Otero and Downing). This shows that women have relatively high savings propensities and also experience more difficulty in accessing formal financial services than do men.

Strengths of Informal Finance

Virtually all of the presentations in the Seminar mentioned strengths or advantages found in informal finance. Some of these are well know such as flexibility, convenience, low information costs for the lender, and high loan recovery rates. Other advantages mentioned are less well known. For example, several presentations focused on how informal lenders resolve the difficult and sometimes costly loan collateral problems (Bouman and Bastiaanssen, Esguerra and Meyer, and Onchan). In some cases the ancient practice of pawning assets is used to reduce the costs of lenders securing loan guarantees. In other cases, informal lenders specialize in accepting certain types of collateral substitutes such as marketing agreements, labor arrangements, or some form of reciprocity.

Another important advantage is that many forms of informal finance provide services at the residence of the client, at a convenient market place, or where clients work (Fernando, Hospes, and Prabowo). Most informal finance is client oriented, while formal intermediaries are often more concerned about their regulators: central banks, government officials, and donor agencies. Intermediaries with a client orientation substantially reduce the transaction costs for clients and make their service attractive even though explicit or implicit interest charges are relatively high. Lender-oriented intermediaries focus on keeping their transaction costs low, charge relatively low interest rates, but often impose procedures on borrowers and depositors that substantially increase their transaction costs to the point where total costs of effecting the financial transaction may be higher than if they were done in the informal market.

Still another attractive feature of some types of informal finance, especially those involving groups, is that loans and deposits are often tied. Individuals can increase their access to loans or credit reserves by proving themselves through deposit performance. This includes building bonds of mutual trust that assure future access to loans through reciprocity. In many cases, informal finance allows participants to gradually enhance their creditworthiness, first through savings, then through borrowing and repaying small loans, and only later gaining access to relatively large loans (Liedholm). This process is particularly important for individuals and firms that start small: women, microenterprises, and poor people.

The rich variety of types of informal finance and the fact that these activities can be found in virtually every nook and cranny of an economy demonstrates the innovative and dynamic nature of at least some parts of the informal financial system. It also demonstrates that informal finance is usually more resilient in the face of adversities that affect the overall economy than is generally true of formal finance, in part, because informal finance is unregulated. In some cases, a few forms of informal finance may exist to avoid regulation or taxes and provide services that are similar to those provided by regulated intermediaries (Vogel).

Some discussion in the Seminar also outlined the inherent weaknesses of informal finance. It is more awkward for informal intermediaries to provide large and long-term loans than it is for formal lenders, and it is also more difficult for informal arrangements to provide the liquidity and security that formal intermediaries ought to be able to furnish to depositors.

RESEARCH PRIORITIES

Much of the research on informal finance in low income countries describes types of informal finance, often through case studies. The bulk of this research has been done by anthropologists and sociologists. Lesser amounts of economic research have stressed documenting the relative importance of informal finance, changes over time in its importance, interest rates charged in informal markets, and the extent of exploitation (Wai). A recent study of informal finance in five Asian Countries, sponsored by the Asian Development Bank, also probed the effects of informal finance on resource allocation, aggregate savings, and monetary management.[6]

Until recently, a major part of the analysis done on informal finance, especially by economists, had a negative tone; it mostly viewed informal finance as being undesirable. From a public relations standpoint, informal finance has an image problem (Ghate). The tone of Seminar presentations, however, was generally positive regarding virtually all forms of informal finance. Many of the participants argued that informal finance plays a vital and positive role in economic development, that it is indispensable in serving the poor, and that a good deal of useful information about the process of financial intermediation can be gleaned from objective analysis of it.

At least six topics for additional research surfaced in the Seminar: (1) methodological problems, (2) looking for generalizations that cut across countries, (3) identifying desirable services provided by informal finance, (4) studying the practices and techniques used in informal finance to reduce transaction costs, (5) broadening the analysis of borrowing costs from just interest charges to include expenses associated with providing collateral, transaction costs, and quality of financial services, and (6) studying the interaction between formal and informal financial markets.

<u>Research methods problems</u>. Because of heterogeneity, small transactions, legality questions, and dispersion of informal finance it is extremely costly to do the large surveys necessary to answer statistically significant questions about the <u>relative importance of informal finance</u> for an entire economy. Unless policy makers are skeptical about the importance of informal finance in their country, these massive studies probably do not yield information worth their costs (Graham). Does it really matter if informal finance provides 40 or 70 percent of the total value of loans in an economy, or whether poor people obtain 50 or 90 percent of their loans from informal sources? It may be sufficient to show that informal finance is important in a few representative industries and within groups that are of policy concern. A more important issue might be <u>understanding how informal finance works</u> and the services it provides. Studies of representative cases may be a less costly way of assembling this information than is doing surveys. At least initially, in many countries, research will have to address the concerns policy makers have about informal finance, no matter how unfounded they may seem (Ghate).

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[6]The study included Bangladesh, India, Indonesia, The Philippines, and Thailand. P.B. Ghate of the Economics Section in the Asian Development Bank coordinated the study.

A related practical problem is how to do a rapid diagnosis of informal finance in a country where little systematic analysis of this topic has been done before (Flammang). Many governments and most large donor agencies do periodic assessments of formal financial markets. If an assessment of informal finance becomes a regular part of these broader assessments, how can researchers contribute insights without doing large numbers of highly detailed case studies or costly surveys whose results may not be available for several years? Should these assessments have as their unit of analysis the type of informal finance (e.g., pawning), an industry (e.g., the textile industry), a target group (e,g., microenterprises), a geographic area (e.g., a central market), or some combinations of these units?

Look for generalizations. Descriptive studies are a critical first step in science and are indispensable in understanding phenomena as complex as informal finance. It would be possible, however, for the small number of researchers who are working on informal finance to spend all of their time only in describing and detailing the multitude of nuances found within a country and in various regions of the world in just rotating savings credit associations (ROSCAS). There is a seemingly endless and evolving variety of these savings and credit groups. While additional descriptive studies of interesting and innovative forms of informal finance are clearly useful, it would be even more useful if research on this topic increasingly focused on deriving generalizations that hold across types of informal finance and countries. Research that uncovers generalization, in turn, would be more useful to policy makers than is purely descriptive research.

Identifying desirable services. Informal finance is popular and persists largely because it provides valuable services to its clients, the vast majority of whom are acting voluntarily. A clearer understanding of the nature and desirability of these services would allow policy makers to design formal finance projects that provide at least some of these services, thereby making formal finance more attractive to individuals and firms currently using informal finance.

Practices and techniques. Expense-reducing innovations, low transaction costs, and creative ways of handling loan guarantees are hallmarks of informal finance. In contrast, formal finance is often characterized by innovations that are directed at regulation avoidance, result in excessive transaction costs, and involve inflexible loan collateral requirements. These hallmarks of informal finance largely explain why it is successful in providing financial services to the poor, while markedly different characteristics of the formal financial system help explain why poor people remain beyond its reach. Research on informal finance may uncover practices and techniques that could be grafted onto formal finance activities and also suggest policy changes that might allow formal intermediaries to expand the formal financial frontier to encompass more low-income individuals and firms.

Borrowing costs. A good deal of the research on informal finance has been based on two important assumptions: interest payments were the main cost of borrowing, and a unit of financial service provided via informal finance was identical to a unit provided by a formal intermediary. Discussion in the Seminar suggested both of these assumptions ought to be tested.

Particularly for borrowers and depositors of small amounts, transaction costs may weigh more heavily in their decisions than do interest payments. Likewise, the costs of providing acceptable loan guarantees to the lender may influence borrowers more forcefully than do interest charges.

Risk considerations should also be included in analyses of borrowing and depositing. For example, a borrower may accept a loan tied to a commodity sales agreement, even though the price paid on the commodity is relatively low, because the lender assumes the risks of changes in commodity prices. Likewise, depositors may prefer to leave their money, interest-free, with trusted moneyguards rather than in interest-bearing accounts at a government bank whose practices do not appear to be businesslike.

Too many studies compare interest rates on informal loans with those levied on formal loans without carefully considering the <u>differences in the services purchased</u>. Occasional borrowers of small amounts, for example, may be willing to pay relatively high rates of interest on their loans from dependable informal lenders because doing so may assure them of future access to emergency loans--essentially a line of credit.[7] The relationship may also commit the lender to intercede for a borrower in vital matters such as minor legal and administrative hassles in a village. These same borrowers may ignore formal loans that carry lower interest rates because additional services are absent or because the formal lender is viewed as being transitory. Additional research on these important issues would clarify the subtle services in informal finance that enhance attractiveness and possibly provide important lessons for formal intermediaries.

<u>Interaction between informal and formal finance</u>. Much of the traditional discussion of informal finance has depicted it as operating largely in isolation from informal finance, partly because of the extensive use of interest rate differentials to measure market segmentation. This has led to some discussion of how to increase <u>connections between formal and informal markets</u>. Increasingly, however, research is showing that formal and informal finance are substantially connected, that economies of specialization explain some apparent market segmentation, and that many people use both formal and informal finance. Connections include users of formal loans who spend their borrowed funds in informal markets, group savings that are deposited in banks, and formal borrowers who make informal loans.

The interactions between formal and informal finance go beyond simply the movement of funds. In some cases informal forms of finance evolve into formal forms (e.g., Cameroon, India, and Japan). In other cases severe repression of formal finance may result in banks converting some of their activities into informal arrangements.

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[7]Individuals who pay a membership fee for the right to carry a credit card that they seldom use, but want it nonetheless for emergencies, are doing the same thing.

There are also a number of cases where formal and semi-formal forms of finance--ACCION, for example--have borrowed a number of ideas from informal finance (Christen).

Additional research that clarifies the extent and desirability of interactions between formal and formal finance could be valuable to policy makers who are designing programs to enhance connections within financial markets.

POLICY IMPLICATIONS

At least five policy strategies for dealing with informal finance were mentioned in the Seminar.

Abolish, Regulate, or Reduce

There was virtually no support among Seminar participants for the traditional view that informal finance should be closely regulated, reduced in scope, and even abolished. Most of the discussion focused on the positive contributions informal finance makes to development and the well being of the poor. Many of the participants were more in favor of trying to enhance the performance of informal finance, or at least learn from it, rather than trying to abolish it.

Benign Neglect

There was some support in the Seminar for essentially leaving informal finance alone. Under this strategy the main consideration is to avoid policies that would inadvertently and unfairly hinder informal finance, as intervention in financial markets has often done.

Link Formal with Informal

A number of Seminar participants, especially individuals representing donor and nongovernmental agencies, supported using informal finance as conduits for formal loans (Seibel and Parhusip). They argued that augmenting the supply of funds available for informal lending may be the only efficient way to effectively lend to poor people. At the same time, there was skepticism expressed about this strategy (Flammang, Hospes). Some attenders, especially those who were not economists and who were not directly associated with donor agencies, argued that infusions of external funds would undermine basic elements that cause success in informal finance. For example, outside funds may lessen the incentive for informal groups to save, increase transaction costs, introduce political decisions into lending, and lessen the incentives to repay loans. An unanswered question is, how much outside funds can be absorbed by informal lenders or groups before the elements that nurture their success are altered adversely? It is also unclear if formal loans targeted for poor people would be any less problematic than earlier formal loan programs that were targeted.

Convert Informal to Formal

Some Seminar discussion revolved around the possibilities of helping informal groups evolve into semi-formal or formal finance (Seibel). Experimental programs sponsored by the West German's Gesellschaft fuer Technische Zusammenarbeit (GTZ) in Cameroon and in Indonesia are providing valuable insights into the possibilities of assisting this evolution. It will be useful for researchers to monitor these efforts over the next few years in order to carefully document results.

Emulate Informal Finance

A final strategy involves learning from informal finance but not attempting to alter its activities through outside interventions. This would largely involve doing research on informal finance to clarify the types of services it provides and the techniques and practices used to provide financial services to the poor. This should include analyses of informal financial activities as part of financial sector assessments as well as more specific analysis of particular forms of informal finance. Useful ideas from these studies might then be grafted onto formal finance programs so that their design more closely emulates informal finance.

APPENDIX A
SEMINAR AGENDA

<u>TUESDAY, OCTOBER 17</u>

7:00 p.m. **Registration, Promenade outside Shenandoah B**

8:00 p.m. **Informal Meeting of Participants, Shenandoah B**

<u>WEDNESDAY, OCTOBER 18</u> **-- All Sessions in Rosslyn A Room**

9:00 a.m. **Seminar Objectives -- Dale Adams**

Session No. 1: <u>Informal Finance and Microenterprises</u>

Chairman: Antonio Gayoso, (S&T Bureau/AID)
Carl Liedholm (Worldwide, Michigan State University)
Mario Lamberte (Philippines, Institute of Dev. Studies)
Discussant: Thomas Timberg (Robert R. Nathan Associates)

10:30 - 11:00 a.m., Coffee Break

Maria Otero and Jean Downing (Latin America, ACCION)
Robert Christen (Chile, PROPESA)
Discussant: James Boomgard (DAI)

12:30 - 2:00 p.m., Lunch, The Vantage Point, 17th Floor

Session No. 2: <u>Informal Finance in Asia</u>

Chairman: Antonio Gayoso, (S&T Bureau/AID)
Nimal Fernando (Papua-New Guinea, Inst. App. Soc. & Ec. Res.)
Tongroj Onchan (Thailand, Kasetsart University)
Discussant: Gershon Feder (World Bank)

3:30 - 4:00 p.m., Coffee Break

Nimal Sanderatne (Sri Lanka, Institute of Policy Studies)
Richard Meyer (Philippines, Ohio State University)
Discussant: Piedad Geron (NEDA, Philippines)

<u>THURSDAY, OCTOBER 19</u>

9:00 a.m. -- Session No. 3, <u>Informal Finance in Asia (cont.)</u>

Chairman: Alan Gelb (World Bank)
Hans Seibel (Indonesia, GTZ)
Otto Hospes (Indonesia, Wageningen University)
Discussant: Marguerite Berger (American University)

10:30 - 11:00 a.m., Coffee Break

Session No. 3 Cont.

Yoichi Izumida (Japan, Utsunomiya University)
Dibyo Prabowo (Indonesia, Universitas Gadjah Mada)
Discussant: Clifton Barton (IMCC/AID)

12:00 - 2:00 p.m., Lunch, Westpark Cafe
Speaker: Hernando de Soto (Peru)
Chairman: Mike Caughlin (Africa Bureau/AID)

Session No. 4: Informal Finance in Africa

Chairman: Sidney Chernick (World Bank)
Carlos Cuevas (Cameroon, The Ohio State University)
Virginia DeLancey (Somolia, American University in Cairo)
Discussant: Sonia Hammam (AID)

3:30 - 4:00 p.m., Coffee Break

Ruvimbo Chimedza (Zimbabwe, University of Zimbabwe)
Parker Shipton (West Africa, On Leave from HIID)
Discussant: Robert Flammang (Louisiana State University)

FRIDAY, OCTOBER 20

9:00 a.m. -- Session No. 5, Informal Finance in Africa (cont.)

Chairman: Richard Meyer (Ohio State University)
Douglas Graham (Niger, Ohio State University)
Robert Vogel (Latin America, IMCC)*
Discussant: Rachael Meghir (OECD)

10:30 - 11:00 a.m., Coffee Break

C.P.S. Nayar (India Overview)
U Tun Wai (Overview, IMF Retired)

12:00 - 1:30 p.m., Lunch -- On Your Own

Session No. 6, Research and Policy Implications

Chairman: Richard Meyer (Ohio State University)

An Agenda for Future Research on Informal Finance
--P.B Ghate (ADB)

Panel Discussion: Relevance of Informal Finance
for Donor Interventions
Chairman: J.D. Von Pischke (World Bank)
Panel Members: Jacob Yaron (World Bank), Beth Rhyne (USAID),
Erhard Kropp (GTZ), and Hunt Howell (IDB)

*Also summarized paper by J.J.A. Bouman and R. Bastiaanssen on Pawning in SE Asia.